[Washington University Law Review](https://openscholarship.wustl.edu/law_lawreview)

Volume 70
Issue 2 *Symposium on Corporate Law and Finance*

January 1992

Limited Liability and Externalization of Risk: A Comment on the Death of Partnership

Robert W. Hillman
University of California, Davis

Follow this and additional works at: https://openscholarship.wustl.edu/law_lawreview

Part of the Business Organizations Law Commons

Recommended Citation

Robert W. Hillman, *Limited Liability and Externalization of Risk: A Comment on the Death of Partnership*, 70 WASH. U. L. Q. 477 (1992).
Available at: https://openscholarship.wustl.edu/law_lawreview/vol70/iss2/10

This F. Hodge O'Neal Corporate and Securities Law Symposium is brought to you for free and open access by Washington University Open Scholarship. It has been accepted for inclusion in Washington University Law Review by an authorized administrator of Washington University Open Scholarship. For more information, please contact digital@wumail.wustl.edu.

LIMITED LIABILITY AND EXTERNALIZATION OF RISK: A COMMENT ON THE DEATH OF PARTNERSHIP

ROBERT W. HILLMAN*

Professor Ribstein believes the advent and spread of limited liability companies (LLCs) will undermine the partnership form of organization.[1] On a normative level, he views this development as desirable because he believes that limited liability *possibly* is efficient and, accordingly, partnership *possibly* is inefficient. The qualifiers assume considerable significance because in an earlier draft of his paper, presented at the F. Hodge O'Neal Conference on Corporate Law and Finance, Ribstein confidently and unqualifiedly asserted the efficiency of limited liability and inefficiency of the partnership form of organization.[2] Now, however, Ribstein offers a highly ambiguous and tentative brief for the efficiency of limited liability. Perhaps in the fullness of time Ribstein will abandon his endorsement of limited liability. But that is unlikely, and the task at hand is to consider the arguments Ribstein presently offers to support his belief that the normative case for limited liability *may be* greatly exaggerated.

My Comment focuses on Ribstein's argument that the potential for externalities caused by limited liability "may be less than has been supposed."[3] In one sense, the artful way he puts his proposition is a considerable improvement over his original, more categorical statement that "the potential for externalities is insufficient to justify restricting the availability of limited liability."[4] But in another sense, Ribstein's attempt to salvage his position comes at the expense of introducing an uncertainty over what that position is. To say that a problem "may be less than has been supposed" is to offer the reader nothing. The problem may

* Professor of Law, University of California, Davis.

1. *See* Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417 (1992).

2. *See* Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, Paper Presented at F. Hodge O'Neal Conference on Corporate Law and Finance, Washington University (Nov. 9, 1991) (copy on file with the author).

3. Ribstein, *supra* note 1, at 439.

4. Ribstein, *supra* note 2.

Washington University Open Scholarship

still be serious, though less so than originally supposed, or the problem may be trivial, or the problem may be something else altogether. Since the balance of his analysis argues that "protecting tort creditors does not justify restricting the development of LLCs,"[5] the reader can only assume that Ribstein believes that the externalities attendant to limited liability are not serious. If this is what Ribstein means, and if he is correct on this point (and I do not believe he is), he has made a large part of the case for the desirability of limited liability.

I. LIMITED LIABILITY, CAPITALIZATION AND INSURANCE

Professor Ribstein offers three reasons owners *may* have an incentive to capitalize adequately and insure under a regime of limited liability: (1) owners of closely held firms will have an incentive to insure against personal tort liabilities arising from their participation in firm activities; (2) owners will have an incentive to insure to protect their investments in firms from claims of tort creditors of the firms; and (3) certain creditors will have the incentive and the leverage to insist on adequate capitalization and/or insurance of the firms with which they do business. Here again, Ribstein qualifies his conclusions by observing that his "goal [is] only to show that externalization is not as serious a problem as has been supposed."[6] Unfortunately, he does not attempt to define how serious the problem is, or if it is serious at all; but, since he does assert that externalization problems "*often* do not exist, even in many very closely held limited liability firms,"[7] we may assume that Ribstein believes limited liability does not give rise to significant externalization problems. If this is not his view, there hardly would have been a reason for Ribstein to include the discussion of externalization in his article.

None of the reasons Ribstein offers adequately addresses the potential for externalization of business risks. To a significant extent, Ribstein's arguments on externalization are weakened by his tendency to talk sometimes about closely held firms,[8] sometimes about publicly held firms, sometimes about both, and sometimes without identifying the type of

5. *Id.*

6. Ribstein, *supra* note 1, at 440 n.101.

7. *Id.* at 440 (emphasis added).

8. Ribstein adds further ambiguity by occasionally referring to "very close corporations," a potentially important concept, but one he does not adequately explain or integrate into his analysis.

https://openscholarship.wustl.edu/law_lawreview/vol70/iss2/10

firm to which he is referring.[9] Ribstein's analysis is at times unitary and at times quasi-unitary,[10] but at most times it fails to accommodate the diversity of firms about which he is writing and thus renders his article an interesting but flawed brief for limited liability. The deficiencies in Ribstein's analysis become apparent on a closer examination of the reasons he dismisses the externalization consequences of limited liability.

A. Insurance against personal tort liability

Consider first the idea that owners will insure against their own tort liability. Here, Ribstein is referring to only closely held firms and professional associations. His argument is brief and may be quoted nearly in full:

> Limited liability does not insulate tortfeasors themselves from liability, but merely prevents liability solely by virtue of ownership status. In the most closely held firms, where undercapitalization is the greatest problem, *owners may have sufficiently participated in the tort*, either as, direct actors or as negligent monitors to be held directly liable.[11]

Hence, Ribstein believes, owners have a significant incentive to insure against tort liability.

It is not clear what Ribstein means when he says "*owners may have sufficiently participated in the tort* . . . to be liable." Presumably Ribstein is saying that, at least in the context of closely held firms, owners are generally liable for tort obligations of employees and firms;[12] to say something less would not advance the position he seems to embrace. Yet we know from reported litigation that owners can and do isolate themselves from the tort liabilities of their employees and firms. Indeed, many of the piercing-the-corporate-veil cases—including chestnuts of the classroom like *Walkovszky v. Carlton*,[13] the taxicab case—illustrate the usefulness of incorporation in protecting owners from the tort liabilities of their employees or their firms.[14] Ribstein's implication that the threat of

9. Moreover, closely held firms differ as much from each other as they do from publicly held firms. *See infra* text accompanying note 32.

10. By quasi-unitary I mean an analysis that ostensibly recognizes the existence of both closely held and publicly held firms but fails adequately to address the distinctions between the two types of firms.

11. Ribstein, *supra* note 1, at 440-41 (emphasis added).

12. This is identical to his original position. *See* Ribstein, *supra* note 2.

13. 223 N.E.2d 6 (N.Y. 1966).

14. *See generally* Robert Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991).

Washington University Open Scholarship

tort liability for owners is substantial, and that therefore owners have an incentive to insure, is thus a dangerous generalization desperately in need of explanation and documentation. Such an unsubstantiated conclusion is either an empirically based declaration, a broad doctrinal assertion, or, perhaps, both. In any event, the burden is on Ribstein to produce evidence supportive of the point that owners *generally* are liable for the torts of firm employees, if that is what he means. Given the tremendous variety of closely held firms and levels of owner participation, I doubt that he can do this. If he cannot, his normative conclusions on limited liability are unwarranted.

B. Voluntary Creditors as Monitor/Demanders of Insurance or Capitalization

Next, and I am taking his points slightly out of order, Professor Ribstein observes that voluntary creditors of limited liability firms will insist on adequate insurance and capitalization.[15] As to which voluntary creditors will make such demands, Ribstein, borrowing from Frank H. Easterbrook and Daniel R. Fischel,[16] first points to long-term creditors, such as managers and employees, who would be hurt by a forced liquidation of the firm's assets. He observes, "Because these voluntary creditors can adjust their terms to reflect the firm's exposure to tort risks, the firm has the incentive to insure and capitalize adequately to cover expected tort claims."[17]

Easterbrook and Fischel were writing about public corporations. Ribstein is not so limiting in his analysis and in fact fails to make *any* distinction at this point between closely held and publicly held firms. It is an exceedingly difficult challenge—perhaps an impossible one—to address limited liability with a unitary analysis that fails to distinguish public from closely held firms.[18] It is therefore unsurprising that his analysis of this point is unconvincing when applied to the closely held firm. At least where the owners are also the managers, they may or may not have the incentive to insure in order to avoid the forced liquidation of the assets of the firm. And in circumstances in which the assets of the firm are significantly less than foreseeable liabilities, the cost of fully insuring

15. Ribstein, *supra* note 1, at 442 .

16. Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 104-07 (1985).

17. Ribstein, *supra* note 1, at 441-42.

18. *See infra* text accompanying notes 25-31.

https://openscholarship.wustl.edu/law_lawreview/vol70/iss2/10

liabilities may significantly exceed the benefits to owner managers seeking to avoid a forced liquidation.

Moving on to employees who are neither managers nor owners, it may seem sensible as a matter of economic reasoning to assume that, when risk to employees is present because of inadequate capitalization or underinsurance, they will bargain for compensation appropriate to the level of risk they bear.[19] However sensible this proposition may seem in the abstract, it does not comport with reality. We have seen, for example, a number of instances in recent years where large, financially distressed corporations have used their own shaky capitalizations and faltering economic performances as a means of demanding wage concessions and give-backs of employee benefits. To cite just one of countless examples, Compaq Computer recently responded to a massive third-quarter loss with an announcement that it would slash prices, layoff fourteen hundred employees (twelve percent of its workforce), and seek concessions from "suppliers," an ominous term to all who may be affected.[20] This hardly seems an appropriate time for the remaining employees of Compaq—or any other company similarly situated—to demand additional compensation or increased capitalization of their employer. And if the idea that employees monitor the wealth of public firms to insure the adequacy of capitalization and insurance seems stretched, it seems even less plausible in the context of closely held firms, at least in periods of labor surpluses.

Ribstein may be on somewhat firmer ground with respect to creditors who are not employees or managers. Banks, for example, regularly include casualty insurance covenants in their loan agreements, particularly when the lending is for the purpose of asset acquisition. Depending on the designation of loss payees, however, such covenants may or may not run to the benefit of the parties who did not negotiate them. The problem is not dissimilar to that raised by secured creditors. The availability of firm assets as security for credit may enhance the creditworthiness of the firm, a development that only sometimes will benefit the firm's other claimants. Upon default, however, the security runs exclusively to the benefit of the protected creditor. Although the possible elimination of that creditor reduces the total claims on firm assets, the remaining claim-

19. *See* Easterbrook & Fischel, *supra* note 16, at 104 ("Employees, consumers, trade creditors, and lenders are voluntary creditors. The compensation they demand will be a function of the risk they face.").

20. *See* Jim Bartimo, *Compaq Posts First Net Loss on Big Charge*, WALL ST. J., Oct. 24, 1991, at B4.

Washington University Open Scholarship

ants are left with a much smaller pool of assets over which their claims extend.

Ribstein points to unsophisticated voluntary creditors such as consumers seeking compensation at rates in excess of risk, which prompts firms capable of doing so to signal or bond their solvency and coverage of tort risks. Again, Ribstein makes the point with sufficient generality to make critical analysis difficult. It may be that financially distressed large corporations such as airlines are forced—by virtue of publicity over bankruptcy prospects—to discount prices to secure consumers. I will assume that it is true even though there are reasons to think it might not be. The important point is that the financial problems of these corporations are well publicized and information is costless, or nearly so. The financial distresses of smaller firms, on the other hand, typically are neither publicized nor reflected in the pricing of their products and services.

Finally, Ribstein fails even to acknowledge the existence of creditors who offer their products and services on uniform terms to all customers. Although the pricing or credit terms of these trade creditors may reflect the aggregate credit risk of all their customers, individual customers typically will be unable to secure lower prices or cheaper credit through the type of signalling and bonding Ribstein describes. To a significant degree, such creditors are involuntary creditors in a position similar to that of tort victims.

C. *Insurance and Capitalization for the Purpose of Protecting the Investments of Owners*

Professor Ribstein's third argument that firms will be adequately capitalized or insured is that owners will desire to protect their investments in their firms from third-party claims. It is true, of course, that owners with significant financial assets or human capital committed to firms will often secure insurance to protect their investments. But this begs the question because the problem of externalization likely is greatest in firms without significant assets. In such firms, the incentive to insure must come from sources other than the desire to protect assets or investments that do not exist.

Admittedly, reasons other than risk aversion may explain the claimed proclivities of firms to purchase insurance. For example, David Mayers and Clifford Smith point to the comparative advantage of insurance firms in the processing of claims and to the monitoring function of insurance firms as a means of moderating the conflict of interest between owners

https://openscholarship.wustl.edu/law_lawreview/vol70/iss2/10

and managers.[21] But in many closely held firms, the owners are the managers, and it is doubtful that a comparative advantage in processing claims is itself sufficient to prompt the purchase of substantial insurance for firms without significant assets.[22]

II. Ribstein's Failed Attempt to Trivialize the Externalization Problem

Professor Ribstein concludes and summarizes his discussion of externalization and limited liability firms with the observation that underinsurance and undercapitalization will be problems only for those firms that do not have substantial assets, do not sell their products in markets in which risks are efficiently priced, and have potentially large tort liabilities.[23] I would define a potentially large tort liability as a cost likely to be externalized because of the inadequacy of the firm's wealth, but I presume Ribstein has something much larger in mind when he speaks of liabilities. In any event, Ribstein believes that firms posing significant externalization risks may be isolated into specific industries—his only example is hazardous waste—and subjected to industry-specific insurance or minimum-capital requirements. It is strange that Ribstein would offer but one example in support of such a bold conclusion, and even as to hazardous waste, the potential liabilities from hazardous substances, materials, and waste are enormous. The problem is not limited to the waste disposal industry, but includes a wide variety of manufacturing companies ranging from the very large to the very small, from the closely held to the publicly held.[24] By sleight of hand, Ribstein assumes away the significance of externalization risks and then uses the assumption to prove his conclusion on limited liability. The world Ribstein is describ-

21. *See* David Mayers & Clifford W. Smith, Jr., *On the Corporate Demand for Insurance*, 55 J. Bus. 281, 285-86 (1982).

22. As support, Professor Ribstein cites David Mayers & Clifford W. Smith, Jr., *On the Corporate Demand for Insurance: Evidence from the Reinsurance Market*, 63 J. Bus. 19 (1990), in which the authors find that closely held insurance firms are more likely to purchase reinsurance than firms whose shares are more widely held. The reinsurance industry, however, is in many respects unique, and it is difficult to draw conclusions from that industry concerning tendencies of noninsurance firms to purchase insurance. The authors, for example, note that reinsurance is a specialized form of financing that may serve to relax regulatory constraints on the ratio of capital to insurance in force. *Id.* at 23.

23. Ribstein, *supra* note 1, at 450. Here again, Ribstein may be speaking of the publicly held firm, although he is not explicit on this point.

24. Perhaps these are liabilities that should, as a matter of policy, be externalized, but that is not the point Ribstein is making.

Washington University Open Scholarship

ing is not of this earth, and his analysis on the scope of the externalization problem is therefore perhaps best relegated to the realm of science fiction.

III. ARE CLOSELY HELD FIRMS DIFFERENT?

Professor Ribstein's failure adequately to distinguish between closely and publicly held firms is apparent in his discussion of the costs of unlimited liability. Here, he tells us that limited liability facilitates diversification, delegation of decisionmaking to managers, reduction of monitoring costs, and transferability of shares.[25] These are essentially the justifications of Easterbrook and Fischel.[26] But those commentators were speaking of publicly held firms and organized securities markets, and they pointedly, and for good reason, did not extend their conclusions to closely held firms.[27] Perhaps Professor Ribstein and I simply have different views of the characteristics of closely held firms; and in any event it is clearly dangerous for either of us to generalize on the point.[28] But at least to the extent owners and managers are one in closely held firms and their investments are, from the perspective of these individuals, substantial, diversification is less of a priority (if it is one at all), monitoring is more feasible than it is for the passive shareholder in the publicly held firm, and transferability of shares is problematic because of the absence of a functioning market for interests in closely held firms.

All of this takes me to my general conclusion on Ribstein's externalization arguments. The case for limited liability of the public firm is strong.[29] The very interesting and more challenging issue, however, is the value of limited liability for closely held firms. Much of Ribstein's article fails to distinguish between the two types of enterprises and attempts to bootstrap limited liability of closely held firms on that of publicly held firms. But in truth, recognition of the distinctions between closely and publicly held firms is essential.[30]

---

25. Ribstein, *supra* note 1, at 448.

26. *See* Easterbrook & Fischel, *supra* note 16, at 93-97.

27. *Id.* at 109-10 (noting that less separation between management and risk bearing had "profound implications for the role of limited liability").

28. *See infra* text accompanying note 32.

29. *But see* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991).

30. This of course is not an original thought; others have offered the same observation. *See, e.g.*, Easterbrook & Fischel, *supra* note 16, at 109-10; Paul Halpern et al., *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117, 148-49 (1980).

https://openscholarship.wustl.edu/law_lawreview/vol70/iss2/10

The uniqueness of closely held firms is a point that Hodge O'Neal made repeatedly. Indeed, it is his most important contribution. O'Neal's orientation was doctrinal rather than economic, but he has had an enormous influence on the way we look at closely held firms. Even Ribstein has recognized that the activity of owner managers is an important factor distinguishing closely held from publicly held firms.[31] If limited liability is to be the norm for all closely held firms, its justification likely lies in reasons other than those applicable to publicly held firms. Ribstein has made the case for limited liability in publicly held firms in which owners are typically passive and not managers. But that case for limited liability has already been made. As to the greater challenge of making the case for limited liability in closely held firms, Ribstein's quasi-unitary analysis misses the mark.

IV. BEYOND RIBSTEIN

I have criticized Professor Ribstein for inadequately taking into account the special characteristics of closely held firms. But the point on the uniqueness of closely held firms is itself a dangerous generalization. Closely held firms are diverse and include those firms in which all owners are active, most owners are active, some owners are active, no owners are active, some owners are active some of the time, and so on. Moreover, closely held firms are involved in every type of business activity, at every scale. They range from the one-person coffee shop to the three-person law firm to the five-hundred-person accounting firm to the ten-person publishing operation to the husband-and-wife grocery store to firms controlled by other firms. Such a complex array of firms may defy treatment through simple economic models and unitary economic theories. At the very least, we need to know more about the firms of which we write and consider the relevance of their diversity to the theories we develop.

More empirical data are necessary to refine our general assumptions and give meaning to our evaluations. Lacking that data, it is critical that commentators state their assumptions and adjust for the variety of firms in their analysis. Even more important is the need to consider carefully what is meant by active participation in a firm. Consider just *some* of the

31. LARRY E. RIBSTEIN, BUSINESS ASSOCIATIONS § 1.02, at 9 (2d ed. 1990) (describing the close corporation by reference to "the corporate contract [that] combines partnership-type owner-management with corporate-type limited liability").

Washington University Open Scholarship

possibilities. Active participation might mean power to control decisionmaking, or actual control over decisionmaking, or acting as an agent of the firm, or ability to monitor significant activities of agents for the firm, or actual monitoring of agents' activities, or ability to direct activities of the firm's agents, or actual direction of agents, or the appearance of all or some of the above, and so forth.

Then, having developed a greater appreciation of the nuances of active participation, it is necessary to consider how and why active involvement with a firm may be relevant to the issue of limited liability. Again, consider just a few of the possibilities:

> Active participation reduces monitoring costs, and therefore the need for limited liability, because shareholders are on the scene and may watch the activities of their co-owners.
>
> Active participation, when tied with a substantial investment, reduces the need for limited liability because the shareholder may not have the same diversification objectives as the passive investor in the publicly held firm.
>
> Active participation may mislead third parties into thinking that owner/managers stand behind the commitments of their firms.
>
> Or, active participation justifies unlimited liability because the power to control carries with it the responsibility for the consequences of the exercise of control.

Once we achieve a greater understanding of the types of firms with which we are dealing, the various roles that owners play, and the importance of active participation to the question of limited liability, the relative efficiencies of limited and unlimited liability may be addressed in a far more sophisticated way than Ribstein's analysis permits.[32]

Finally, there are important public-choice issues that need more exploration. Ribstein has offered an off-the-shelf theory. It is a theory in search of an application, and it is likely that certain groups will find it quite appealing. Consider in this regard the supposed reforms of limited-partnership law that have relaxed restrictions on the control activities of limited partners and at the same time preserved the principle of their limited liability.[33] Ribstein apparently does not view these developments

32. Limited liability may be efficient for a firm in which all or some investors are passive—one that is similar to the classic limited partnership or the public corporation—while unlimited liability is preferable to firms dominated by "active"—the ambiguity notwithstanding—owner/managers. In any event, in many ways closely held firms are more complex and diverse than their public counterparts, and the limited liability regime developed for the public corporation may be poorly suited for some, but not all, closely held firms.

33. *Compare* UNIFORM LIMITED PARTNERSHIP ACT § 7 (1916) (limited partner not liable *to*

https://openscholarship.wustl.edu/law_lawreview/vol70/iss2/10

as dramatic, but he ignores the profound changes in limited-liability partnership law that have occurred over the last twenty years. Although there is some academic support for the relaxation of control-activity restrictions, the changes have not been accompanied by a principled and spirited exchange of views on the policy desirability of allowing increased activity by limited partners. Instead, reform has been the product of the pressure brought to bear by partnership syndicators and the professionals who either represent them or are sensitive to their needs.[34] And why? Who speaks on the issue of limited liability for claimants of the firm such as trade creditors, employees, and the like? Since limited liability is, in the larger scheme of things, a relatively recent innovation, why has it become such a persistent issue of law reform? Is it because of the economic efficiencies it offers? At least as applied to closely held firms, those benefits have not been established.

---

creditors unless partner takes part in the control of the business) *with* REV. UNIFORM LIMITED PARTNERSHIP ACT § 303 (1976, as amended in 1985) (limited partner not liable *to third parties* unless takes part in the control of the business and then only liable to those third parties who transacted business with the partnership believing the partner was a general partner, with extensive activities listed (e.g., acting as an employee of the limited partnership) that, by themselves, do not constitute participation in the control of the partnership).

34. Even today, in the process of revising the Uniform Partnership Act, we see repeated pleas by participants in that project to make the Act conform with limited partnership law, an argument designed to make the tail wag the dog.

Washington University Open Scholarship